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AUTHOR	Crawford, Clarence C.
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ABSTRACT

In the current implementation of the Federal Direct Student Loan Program, there are lessons to be learned from past higher education loan programs, better ways to administer these programs and direct loans, and points to remember as direct loans are implemented. Current guaranteed student loan programs have been the subject of scrutiny recently because of rising costs related to defaulted loans and Department of Education inefficiencies. Loan program problems have involved program structure, weak gatekeeping procedures, and inadequate financial and management systems. Many of these problems will require the continued attention of the Congress and the Department of Education regardless of implementation of a new direct loan structure. Other issues that could be addressed include continuing to strengthen the Department's gatekeeping procedures, strengthening the incentives for effective loan servicing, and expediting efforts to develop a comprehensive plan to correct Department financial and management systems. A comprehensive strategy is needed for the direct loan conversion effort which should address the management and oversight of the conversion, human resources and support requirements, loan servicing and support to schools and students, and management and the winding down of the guaranteed loan portfolio. (Lists 13 related Government Accounting Office publications.) (JB)

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DIRECT STUDENT LOANS

The Department of Education's Implementation of Direct Lending

Statement of Clarence C. Crawford
Associate Director
Education and Employment Issues
Human Resources Division

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Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss the Department of Education's implementation of the Federal Direct Student Loan Program. You asked that we focus on the Department's experiences operating the current guaranteed student loan program--the Federal Family Education Loan Program--and the lessons learned from these experiences as the Department begins to implement and transition to direct lending.

As you know, we began reviewing the direct lending issue about 2 years ago as the Congress was preparing to reauthorize the Higher Education Act of 1965, as amended. In November 1992, we reported that significant cost savings could accrue to the government by making loans directly to students and replacing the guaranteed student loan program--whereby private lenders make loans that the federal government ultimately guarantees against default.[1] These savings were mostly attributed to changes in the government's income from the net interest margin--the difference between the interest rate charged to borrowers and the government's cost of borrowing--and the elimination of interest subsidy payments to lenders. Besides such cost savings, direct lending would require a less complex loan delivery system, benefiting the government through more efficient and cost-effective loan servicing and providing a simpler system for students and schools. But some of the schools' student aid administrators and business officers with whom we spoke shared with us their concerns about the Department's ability to manage a direct lending program. Poor management of a direct lending program by the Department of Education could inhibit access to loans by eligible borrowers and trigger more loan defaults, which could substantially erode any potential cost savings.

In our report, we cautioned that if the views of student aid administrators and business officers are indicative of the views of others, realizing the potential savings from direct lending will require substantial effort on the part of both the schools and the federal government. We suggested that for direct lending to succeed, the Department of Education will need to (1) work with the postsecondary education community and (2) provide strong program leadership as it prepares to implement direct lending.

The Higher Education Amendments of 1992 authorized a direct loan demonstration program to operate concurrently with the guaranteed student loan program. The demonstration is to operate with loans

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[1]Student Loans: Direct Loans Could Save Billions in First 5 Years with Proper Implementation (GAO/HRD-93-27, Nov. 25, 1992).

made from July 1, 1994, through June 30, 1998. The Department is selecting about 250 schools to operate with direct loans and a like number of schools to serve as a control group by continuing with guaranteed loans. We will evaluate the demonstration, reporting to the Congress before January 1, 1997, on our interim results and issuing a final report before May 1, 1998. The remaining schools would continue participating in the guaranteed program, generally unaffected by the demonstration.

Also, the administration is proposing that the Student Loan Reform Act of 1993, through H.R. 2264 (which passed the House on May 27, 1993) and S. 920, would replace the direct loan demonstration and authorize the implementation of direct lending with a phased-in program beginning in July 1994. Beginning in school year 1998, all new student loans would be direct loans. The Department would continue to operate a guaranteed loan program, servicing loans and collecting funds from the outstanding loan portfolio.

STUDENT LOANS--A HIGH-RISK PROGRAM

The current guaranteed student loan program has been the subject of great scrutiny during the last few years primarily because of the rising costs related to defaulted loans. We, as well as the Department's Office of the Inspector General, the Office of Management and Budget, congressional committees, and others, have reported numerous inefficiencies in the Department's management and administration of the program.

The guaranteed loan program has provided billions of dollars of financial aid to postsecondary students since its inception in 1965. It has been very successful in providing access to a postsecondary education for millions of students. But with this access came a variety of abuses reported in the media, including ineligible students receiving loans, schools (mostly for-profit trade schools) focused more on making money than on providing their students an education, and lenders making loans to fictitious students and fraudulently collecting federal funds for defaulted loans that were not properly made or serviced. These kinds of abuses have occurred, in part, because the Department of Education has had difficulty appropriately balancing borrowers' easy access to loans with proper controls to protect the federal government's financial interest.

As you know, the Comptroller General has designated guaranteed student loans a high-risk program.[2] We reported on the

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[2]Programs were selected as high risk because they had weaknesses in internal controls or in financial management systems, and correcting these problems is essential to safeguarding scarce government resources and ensuring their efficient and effective use.

vulnerabilities in the loan program in December 1992 in one of our 17 high-risk reports.[3] We discussed many of the problems, their principal causes, and our suggestions for improving the guaranteed loan program. Our high-risk report and others we issued during the last few years form the basis for our statement today. (See attachment for list of related products.)

STUDENT LOANS--A HISTORY OF PROBLEMS

The loan program has been besieged with a variety of problems, the causes of which are many and the fixes for which are far from simple. The program is complex, which contributes to its vulnerability to abuse. For example, there are over 7,500 schools, 7,800 lenders, and 46 guaranty agencies sharing responsibility for annually making about 4 million loans--averaging less than $2,900 each--to millions of borrowers. The Department makes interest subsidy payments and pays claims for defaulted loans without adequate documentation, relying on billings submitted by lenders and guaranty agencies. In addition, the program has an inherent risk built into it: most loans are made to borrowers who have little or no credit history. This, not surprisingly, contributes significantly to high default rates.

The Congress and others recognize that there is an inherent risk in a program of this nature. But there are also known vulnerabilities in how the program is being managed that can and should be addressed. We have reported on these kinds of vulnerabilities several times,[4] and they include:

Program Structure

Within the current structure, the Department has struggled to manage the numerous participants as it made $15 billion in new loans in fiscal year 1992, and guaranteed a loan portfolio totaling $63 billion as of September 30, 1992. The behavior of all participants--schools, students, lenders, and guaranty agencies--has not been in the best interest of the American taxpayer. This has led to abuses, such as lenders making loans to fictitious borrowers, guaranty agencies not adequately reviewing and paying defaulted loan claims or maintaining accurate loan data on borrowers, schools misrepresenting their academic capabilities, and

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[3]High-Risk Series: Guaranteed Student Loans (GAO/HR-93-2, Dec. 1992).

[4]Including High-Risk Series: Guaranteed Student Loans (GAO/HR-93-2, Dec. 1992); Financial Audit: Guaranteed Student Loan Program's Internal Controls and Structure Need Improvement (GAO/AFMD-93-20, Mar. 16, 1993); and Stafford Student Loans: Millions of Dollars in Loans Awarded to Ineligible Borrowers (GAO/IMTEC-91-7, Dec. 12, 1990).

students falsifying their loan applications. In addition, the Department lacks the resources and enforcement tools to appropriately monitor and oversee this large group of participants.

Additionally, the program lacks adequate performance incentives for lenders, guaranty agencies, and schools participating in the program. For example, we reported that lenders and guaranty agencies are paid for defaulted loans if certain servicing steps (called due diligence) are taken. But guaranty agencies generally pay lenders 100 percent of loans that default, and the agencies generally receive 100 percent from the Department if they are unsuccessful in keeping a loan from defaulting. After the Department pays default claims, the guaranty agencies retain the loan and continue trying to collect it, retaining 30 percent of amounts that they may subsequently collect. According to Department data, during fiscal year 1991, about 13 percent, or more than $200 million, of guaranty agency revenues were from collections on defaulted loans. Therefore, the agencies have more incentives to collect on loans after they are defaulted than to work with borrowers and lenders to prevent loans from becoming defaulted because (1) agencies can earn additional revenue from default collections but not from performing due diligence procedures and (2) default-prevention incentives have not been as effective as intended.

Gatekeeping Procedures

The Department's gatekeeping procedures for determining which schools can participate--and continue to participate--in the program have been weak. The Department's oversight has been minimal, and it must rely on others--accrediting organizations and state licensing agencies--to ensure the quality of education that schools provide. Such slack oversight practices have not been successful in weeding out schools that exhibit abusive behavior, such as collecting tuition payments for marginal instruction. For example, the lure of plentiful financial aid for proprietary school students, and abusive practices of some proprietary schools--including fraud--has had a disproportionate impact on defaults. In 1990, students attending these schools represented 41 percent of borrowers, but 77 percent of those who had defaulted loans.

Financial and Management Systems

The Department's financial and management systems are not adequate to provide the information necessary to manage and oversee the program and protect the federal interest. To illustrate:

-- Management information systems contain data that are not always accurate and timely, limiting the systems' use for compliance and evaluation purposes. For example, in a sample of loan data reported to the Department by guaranty agencies, 2 of 10 agencies that we reviewed did not send in their monthly

billings until after the Department's fiscal year 1991 cut-off date. This late reporting resulted in these agencies receiving a higher than appropriate reimbursement for defaults. Both of the agencies we reviewed that submitted reports after the year-end cut-off date would have been reimbursed by the Department at a lower rate if they had reported on time.

-- A complete and accurate student loan data system was lacking, which contributed to loans being made to borrowers in default or otherwise ineligible for loans. This condition exists, in part, because data submitted by guaranty agencies in many instances are incomplete, inaccurate, and not timely, and the Department has little means to ensure that accurate data are submitted. For example, our analysis of Department data showed that about $42 million of new loans were made to students in fiscal year 1988 who had defaulted on earlier loans. Another $5 million may have been loaned to students during the 12 months ending August 1988 in excess of annual statutory loan limits. In addition to making these loans, the government paid interest subsidies to lenders over the life of the loans.

-- A shortage of qualified staff plagues the management of the guaranteed loan program. The program office has a shortage of adequately trained staff, and some staff members lack the appropriate skills, such as finance, information systems, data analysis, planning, and policy making skills. For example, there are few employees with financial or accounting backgrounds to administer the $15 billion in new loans made annually.

-- Financial audits do not include in-depth examinations of the accuracy and validity of lenders' and guaranty agencies' claims for interest subsidies, defaulted loans, and administrative cost allowances. For example, at times, records supporting the Department's payments to lenders and guaranty agencies have been missing, incomplete, or inaccurate. Also, the Department has relied heavily on an honor system in its financial management activities. It pays over $5 billion annually to lenders and guaranty agencies based on unaudited summary billings.

American taxpayers, therefore, have been underwriting a program that lacks the oversight and internal controls needed to properly safeguard its substantial investment. The Department of Education, schools, lenders, and guaranty agencies should do more to control the program's risks.

FIXING KNOWN PROBLEMS IN THE STUDENT LOAN PROGRAM

Many of the problems we identified will require the continued attention of the Congress and the Department of Education whether

student loans continue to be provided by private-sector lenders and guaranteed by the government or made directly by the government. The Congress, the Department, and the Office of Management and Budget have recognized these kinds of problems and attempted to correct many of them. For example, the Department has worked to correct staffing inadequacies, controls over schools, and oversight of lenders and guaranty agencies, and to improve its financial management. Nevertheless, the urgency of resolving these kinds of problems is important because under either the existing legislation in which the Department will operate the direct lending demonstration program or the phased-in program as specified in H.R. 2264, the Department of Education will be operating two student loan programs concurrently. Whether private lenders or the government originate student loans, it is imperative to fix the Department's underlying data collection and supporting systems as soon as possible.

What can be done to address the Department's management efficiencies? One principal issue that deserves attention is the structure of the guaranteed student loan program. There are more participants--lenders and guaranty agencies--than are needed to effectively operate the program. With the automation and electronic transfer capabilities in existence today, providing borrowers access to loans can be ensured with fewer participants. A program with fewer participants would also make the Department's oversight and monitoring responsibilities more manageable, as well as streamlining the loan delivery system for both schools and students.

We want to discuss several other issues that we believe should be addressed, whether the current system is retained or direct lending is implemented in some fashion.

-- The need to continue strengthening the Department's gatekeeping procedures to more effectively determine the fiscal and administrative capabilities of schools seeking to participate in student aid programs, as well as those wanting to continue. Part of this effort should include the use of outcome measures, such as school completion rates and job placement rates.

-- Strengthening the incentives for effective loan servicing and default prevention by lenders, guaranty agencies, and servicers, partly by establishing results-oriented default prevention incentives, and partly by comparing the needs and benefits of the current number of guaranty agencies with the benefits of consolidating the guaranty agencies.

-- Expediting efforts to develop a comprehensive plan to identify and correct longstanding problems in the Department's financial and information management systems for its student loan programs.

In our high-risk report, we recognized that direct lending (we were referring to the demonstration program) was on the way to becoming a reality. We suggested that the Department proceed cautiously with the direct lending demonstration program to ensure its proper implementation and subsequent evaluation. We wish to reaffirm that message today, whether the Department phases in full implementation or operates the demonstration program as authorized by the 1992 amendments.

IMPLEMENTING DIRECT LENDING

You also asked that we comment on the key areas that the Department should focus on as it prepares to implement direct lending. As we discussed earlier, poor management by the Department of Education could increase the risk of failure as direct lending is implemented. The primary loser in such a scenario would be students and schools if access was somehow compromised, and the federal government and taxpayers if defaults were to increase. To minimize these risks, the Department needs to keenly focus on properly implementing direct lending. While we have not performed an in-depth review of this subject, we believe a comprehensive strategy is needed for the direct loan conversion effort. This strategy should address the management and oversight of the conversion, human resources and support requirements, loan servicing and support to schools and students, and management and the winding down of the guaranteed loan portfolio. Along these lines some of our specific observations, on the basis of our past work, include:

-- Management and Oversight Ensure that the Department's management structure is adequately overseeing the design and implementation of direct lending and the winding down of the current guaranteed loan system. Among its responsibilities are the development of specific project and acquisition plans and timelines and the early identification and prompt management of risks, along with the development of the information and financial management systems to support direct lending, which includes interaction with the existing guaranteed student loan systems.

-- Human Resources and Support In determining and obtaining the resources needed to implement direct lending, the Department should ensure that it is identifying adequate technically qualified staff, contract support, equipment, and space. For example, it must address how it will manage the staffing needed for the development and implementation period, as well as articulate how it will handle winding down the guaranteed loan program.

-- Loan Servicing and Support to Schools and Students Assuring access to student financial assistance must continue to be a principal objective. The Department must continue to develop

and execute contracts that will encourage the efficient servicing of loans and provide proper incentives for default prevention. It must issue necessary rules and regulations in a timely manner, develop a strategy for providing training and other assistance to schools as they assume new responsibilities under direct loans, and provide "on demand" assistance to students and school financial aid administrators and business officers.

-- Guaranteed Loan Program Wind Down Develop a strategy for the orderly management and winding down of the current $63 billion loan portfolio. The Department should explore alternative strategies for winding down the current program and provide back-up systems as lenders and guaranty agencies wind down or stop participating in the guaranteed loan program.

In summary, implementing direct lending will be a challenge to the Department of Education. It must be prepared to promptly work out kinks in the program to minimize the risks. If limitations on access or increases in loan defaults occur, the Department must identify and address them early to ensure the integrity of direct lending as the principal federal provider of financial aid to postsecondary students.

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Mr. Chairman, that concludes my statement. My colleagues and I would be happy to answer any question that you or the other Committee members may have.

Attachment

RELATED GAO PRODUCTS

Department of Education: Long-Standing Management Problems Hamper Reform (GAO/HRD-93-47, May 28, 1993).

Financial Audit: Guaranteed Student Loan Program's Internal Controls and Structure Need Improvement (GAO/AFMD-93-20, Mar. 16, 1993).

High-Risk Series: Guaranteed Student Loans (GAO/HR-93-2, Dec. 1992).

Transition Series: Education Issues (GAO/OCG-93-18TR, Dec. 1992).

Student Loans: Direct Loans Could Save Billions in First 5 Years With Proper Implementation (GAO/HRD-93-27, Nov. 25, 1992).

Guaranty Agency Solvency: Can the Government Recover HEAF's First-Year Liquidation Cost of $212 Million? (GAO/HRD-93-12BR, Nov. 13, 1992).

Guaranteed Student Loans: Prompt Payment of Origination Fees Could Reduce Costs (GAO/HRD-92-61, July 24, 1992).

Guaranteed Student Loans: Eliminating Interest Rate Floors Could Generate Substantial Savings (GAO/HRD-92-113, July 21, 1992).

Student Financial Aid: Education Can Do More to Screen Schools Before Students Receive Aid (GAO/HRD-91-145, Sept. 27, 1991).

Student Loans: Direct Loans Could Save Money and Simplify Program Administration (GAO/HRD-91-144BR, Sept. 27, 1991).

Student Loans: Characteristics of Defaulted Borrowers in the Stafford Student Loan Program (GAO/HRD-91-82BR, Apr. 26, 1991).

Stafford Student Loans: Millions of Dollars Awarded to Ineligible Borrowers (GAO/IMTEC-91-7, Dec. 12, 1990).

Defaulted Student Loans: Analysis of Defaulted Borrowers at Schools Accredited by Seven Agencies (GAO/HRD-90-178FS, Sept. 12, 1990).

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